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C O N F I D E N T I A L SECTION 01 OF 03 BAGHDAD 003876

SIPDIS

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TAGS: EFIN ECON ENRG EPET MOPS MARR PGOV PINR IZ
SUBJECT: THE IRAQI BUDGET DILEMMA - TOUGH CHOICES

REF: BAGHDAD 3805

Classified By: CHARGE D'AFFAIRES DAVID M. SATTERFIELD FOR REASONS 1.4 (b) AND (d).

¶1. (C) Summary: Iraq faces hard choices on its budget, with difficult policy considerations for the USG. Iraqi ability to meet expenditure needs for normal functions, reconstruction, and security are severely constrained. Funding estimates for security needs have risen substantially, with "high estimates" largely linked to sustainment costs, not weapons procurement. The ability to ramp up energy output, hence revenues, is hindered by attacks on infrastructure and a limited ability by the GOI to proceed with capital investment projects. Subsidy reform is on the table, but only modest (at best) alterations appear likely, absent political will from the GOI, lack of administrative preparation, and no public education on the subject. Finally, political concessions in the draft Constitution to regional interests have muddied the waters regarding revenue sharing. The Iraqis will need to address this last point themselves. We are prepared to engage them on these issues. End summary.

An Exploding Security Budget

¶2. (C) Minister of Finance Allawi is beginning to understand that his politically difficult 2006 budget intention to reduce food and fuel price subsidies by 25 percent next year -- in hopes of achieving a $2 billion savings in order to increase by nearly 50 percent Iraqi MoD/MoI expenditures, from $2.5 billion to $3.6 billion -- will not be met. We have informed him that we believe that 2006 budget security costs will range between $7 billion and $11 billion, depending on GOI sustainment costs. Another wildcard is that the current ministers of defense and interior have expressed interest in expanding their respective force levels, the Ministry of Defense (MoD) modestly and the Ministry of Interior (MoI) significantly. These issues have not entered into the Iraqi political debate; nor is it clear that that they will before the December elections. It should be emphasized that neither "high" nor "low" security budget projections include significant new weapons systems.

¶3. (C) Informally, Allawi has told us that under an optimistic assumption of sustained high oil export revenues, the GOI could possibly find an extra $3.4 billion for the $7 billion-plus security package. He remains skeptical that either MoI or MoD can absorb the demands that this extra money would place on them. In addition, he remains committed to avoiding security budget leakage, such as resulted in an apparent $1 billion shortfall in defense accounts in 2004-2005, a scandal now coming to light that seems to implicate the previous government.

Tough Economic Reforms Without a Net

¶4. (C) Allawi strongly believes that some kind of social safety net must accompany implementation of subsidy reforms to provide political credibility. Previously, he favored limiting the food basket to essential items only (i.e. ridding it of soap, for example), regardless of his larger reform plan. The Ministry of Labor and Social Affairs (MOLSA) also is interested in establishing a safety net program, albeit with a poverty-reduction focus. Common to both proposals is a desire to mitigate the situation of the most vulnerable members of Iraqi society. USAID contractors have begun to do some work for MOLSA in this area and suggest that some kind of safety net can be developed to protect the poorest sector of Iraqi society by either 2007 or 2008 at a cost of about $333 million. (Note: We have not seen anything in Allawi's proposed 2006 budget that would allocate money for a safety net. End note).

Changing the Form is Not Reducing the Subsidy

¶5. (C) Allawi told us just before his departure for IMF discussions that he is contemplating a scheme by which a reduction of the food and fuel subsidies would be offset by a stipend of $200 given to each Iraqi citizen (the "Alaska

model"). (Comment. Although this proposal serves a GOI political imperative, it does not address the GOI's fundamental budget imbalance. Furthermore, Iraq is hardly in a position to issue its citizens a dividend, no matter the form, when it is in such dire fiscal straits. End comment.)

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MO's Ability to Increase Oil Output in 2006 in Doubt
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¶6. (C) The Ministry of Oil's (MO) ability to increase oil revenue in 2006 will be directly affected by world oil prices. Benefits gained from increased oil revenue must be weighed, however, against the MO's failure to maintain, modernize, or protect its critical infrastructure. Its failure to do so invites a repeat of the situation in summer 2005, when failures in domestic production and refining caused an unanticipated increase in fuel imports from Turkey. While the MoF recently paid Iraq's arrears to Turkish oil companies that had accrued during the first half of 2005, the MO and MoF agreed in August that projected import expenses of roughly $1.2-$1.6 billion for the remainder of the year would be covered from the virtually unused $3 billion MO capital budget.

¶7. (C) The MO has left largely untouched its 2005 capital budget due to an apparent procedural misunderstanding of how the funds would be released: the MO is waiting for the funds to be transferred to its account before drafting proposals, while the MoF is awaiting submission of MO projects approved by the inter-ministerial committee on budget expenditures before providing funding. Although the procedure was clarified in May, the MO acknowledged that it was too late in the year to develop a full slate of sound and responsible projects. The MoF subsequently authorized the MO to spend $1.8 billion on infrastructure security (including funding for the first four Strategic Infrastructure Battalions or SIBs), as well as on a small number of capital projects. Given the few months remaining in calendar 2005 and the Ministry's weak capacity to draft tender documents and arrange letters of credit, it is highly unlikely that the MO will succeed in spending the entire sum of $1.8 billion remaining in this account.

¶8. (C) The MO's inability to make best use of its capital budget is especially troubling, given that the rate of pipeline failures has kept pace with the already considerable rate of insurgent interdictions. The Kirkuk-Bayji 40" line, for example, has suffered a series of failures that have kept it off-line for over two weeks. Although the incidents remain under investigation, the Chief of the Infrastructure Coordination Cell reported to DPM Chalabi September 12 that his investigation indicated that the initial breach in early September had been due to a poorly-implemented repair. The insurgency appears to have caused yet another break in the line on September 19. This latest break starves the already-depleted Bayji refinery of crude oil, putting the plant out of service for no less than a week as it is now necessary to conduct a "cold start." Although a second 40" pipeline is expected to come into service in the first quarter of 2006, without substantial additional investments in security, this line too is likely to be rapidly and prematurely weakened by repeated insurgent attacks.

Oil and the Constitution

¶9. (C) The Constitution, in its most recent draft, creates budgetary ambiguity while it attempts to solve the regional/sectarian-based conundrums of resource sharing. The document addresses Iraq's petroleum resources on three distinct levels: ownership, management, and disbursement of funds. Regarding ownership, Article 108 (109 in a previous draft) reaffirms TAL language that "oil and gas are owned by all the people of Iraq in all the regions and governorates."

¶10. (C) According to article 109 (110 in a previous draft), the federal government is charged with distributing revenue fairly, in proportion to the population distribution in Iraq, and setting aside for a defined period of time special allotments for "damaged regions that were unjustly deprived (of such revenue) by the former regime, and the regions that were damaged afterward in a way that ensures balanced development in different areas of the country." This language is ambiguous, but may imply distribution to subnational units based on their proportion of the total population. The special allotment for damaged regions may mean temporary special disbursements for the Kurdish and Shia areas. Ultimately, the constitution merely postpones a decision until the next national assembly by stipulating that the assembly shall pass a law on how such revenue sharing is to be accomplished. The assembly may set a permanent formula (we can imagine the Kurds seeking this) or may determine a one-time allocation of a fixed amount (Iraqi federalists

would likely prefer this option).

¶11. (C) Article 109 also stipulates that "(the federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from present fields..." By referring only to present oil fields, this provision implicitly distinguishes between the management of existing fields, in which the federal government takes the primary role, and the undefined management rights over still to be discovered fields. The central government is charged with developing a policy for future oil and gas resources, together with the regional and governorate authorities. However, it is possible that a contest between the regions and the center for control could develop, despite the constitution's goal of compelling the central government and the regions to seek a political approach that will include some form of revenue sharing. The regions and governorates could also take this provision as encouragement, to put their resources into developing new fields, where they may have more influence, to the detriment of re-working existing fields. Similar difficulties may arise where fields are not clearly in any one region's control.

¶12. (C) Finally, because the draft constitution contemplates that some elements of the oil and gas sector will be subject to shared authority, special provisions govern when conflict between federal and non-federal regulation arises. Should a dispute emerge between the federal government and a governorate, for example, over an issue in which power is shared, Article 111 states that priority will be given to the regional law. Article 117(2) seemingly makes similar in-roads on federal authority, providing "in the case of a contradiction between regional and national legislation in respect to a matter outside the exclusive powers of the federal government, the regional authority shall have the right to amend the application of the national legislation within that region." Nevertheless, the oil and gas provisions in the constitution still establish substantive standards, i.e., fair distribution, balanced development, highest benefit to the Iraqi people, that are presumably applicable to whichever governmental entity is regulating.

¶13. (C) Clearly, there are budgetary implications here with which Iraqis have yet to grapple. Moreover, given that these issues remain highly controversial, they ultimately may land at the federal Supreme Court, whose authority includes issuing decisions on disputes between regions and between regions and the central government. The Embassy is entering into broad interagency discussions to better define any potential pitfalls in the economic sphere further down the road. In the months following the Constitutional referendum and election, we will engage the Iraqis on the points outlined above.
Satterfield